Analysis of Financial Statements

Chapter 17

Wild and Shaw

Fundamental Accounting Principles

25th Edition

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Chapter 17 Learning Objectives

CONCEPTUAL

C1 Define the building blocks of analysis and the standards for comparisons.

ANALYTICAL

A1 Summarize and report results of analysis.

A2 *Appendix 17A*—Explain the form and assess the content of a complete income statement.

PROCEDURAL

P1 Explain and apply methods of horizontal analysis.

P2 Describe and apply methods of vertical analysis.

P3 Define and apply ratio analysis.

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Learning Objective C1

Define the building blocks of analysis and the standards for comparisons.

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Purpose of Analysis

Common goal of financial statement analysis for both external and internal users is to evaluate company performance and financial condition and to assist in evaluating:

1. Past and current performance
2. Current financial position
3. Future performance and risk

Internal Users
Managers
Officers
Internal Auditors

External Users
Shareholders
Lenders
Suppliers

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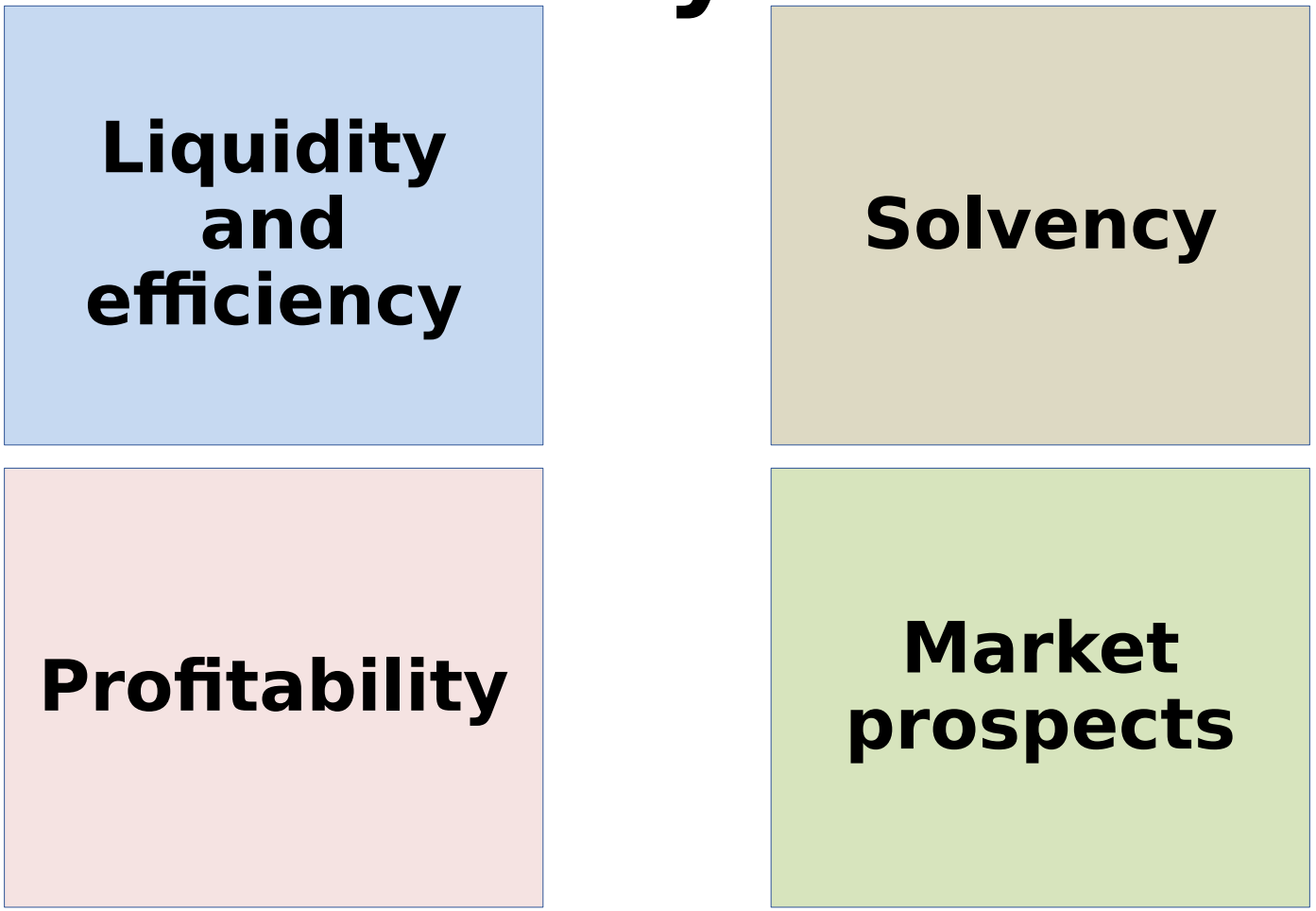
Building Blocks of Analysis



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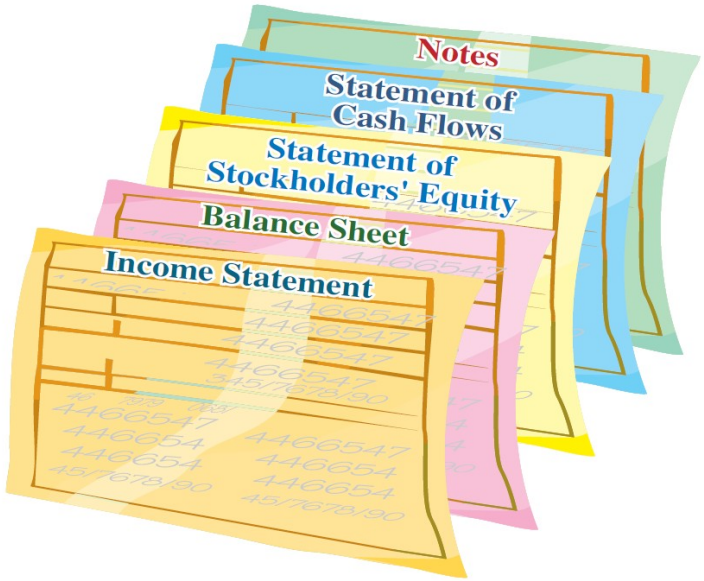
Information for Analysis

General-purpose financial statements:

1. **Income Statement**
2. **Balance Sheet**
3. **Statement of Stockholders' Equity**
4. **Statement of Cash Flows**
5. **Notes to the Financial Statements**



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Standards for Comparison

When we interpret our analysis, it is essential to compare the results we obtained to other standards or benchmarks.

- Intracompany
- Competitor
- Industry
- Guidelines

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Tools of Analysis

Horizontal Analysis

Comparing the financial condition and performance across time.

Vertical Analysis

Comparing the financial condition and performance to a base amount.

Ratio Analysis

Measurement of key relations between financial statement items.

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Learning Objective P1

Explain and apply methods of horizontal analysis.

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Horizontal Analysis

Horizontal analysis is the review of financial statement data *across time*.

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Comparative Statements: Dollar Change

Dollar change	=	Analysis period amount	–	Base period amount

- When measuring the amount of the change in dollar amounts, compare the analysis period to the base period.
- The analysis period refers to the financial statements under analysis.
- The base period refers to the financial statements used for comparison.

Learning Objective P1: Explain and apply methods of horizontal analysis.

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Comparative Statements: Percent Change

$$\text{\% change} = \frac{\text{Analysis period amount} - \text{Base period amount}}{\text{Base period amount}} \times 100$$

- **When calculating the change as a percentage, divide the amount of the dollar change by the base period amount, and then multiply by 100 to convert to a percentage.**
- **Four cases require additional analysis**

Case	Analysis Period	Base Period	Change Analysis: Dollar	Change Analysis: Percent
A	$ 1,500	$(4,500)	**$ 6,000**	**—**
B	(1,000)	2,000	**(3,000)**	**—**
C	8,000	—	**8,000**	**—**
D	0	10,000	**(10,000)**	**(100%)**

Learning Objec
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Comparative Balance Sheets

APPLE INC. Comparative Year-End Balance Sheets

$ millions	Current Year	Prior Year	Dollar Change	Percent Change
Assets				
Cash and cash equivalents	$ 48,844	$ 25,913	$ 22,931	88.5%
Short-term marketable securities	51,713	40,388	11,325	28.0%
Accounts receivable, net	22,926	23,186	(260)	(1.1)%
Inventories	4,106	3,956	150	3.8%
Vendor nontrade receivables	22,878	25,809	(2,931)	(11.4)%
Other current assets	12,352	12,087	265	2.2%
Total current assets	162,819	131,339	31,480	24.0%
Long-term marketable securities	105,341	170,799	(65,458)	(38.3)%
Property, plant and equipment, net	37,378	41,304	(3,926)	(9.5)%
Other noncurrent assets	32,978	22,283	10,695	48.0%
Total assets	$338,516	$365,725	$(27,209)	(7.4)%
Liabilities				
Accounts payable	$ 46,236	$ 55,888	$ (9,652)	(17.3)%
Other current liabilities	37,720	33,327	4,393	13.2%
Deferred revenue	5,522	5,966	(444)	(7.4)%
Commercial paper	5,980	11,964	(5,984)	(50.0)%
Current portion of long-term debt	10,260	8,784	1,476	16.8%
Total current liabilities	105,718	115,929	(10,211)	(8.8)%
Long-term debt	91,807	93,735	(1,928)	(2.1)%
Other noncurrent liabilities	50,503	48,914	1,589	3.2%
Total Liabilities	248,028	258,578	(10,550)	(4.1)%
Stockholders' Equity				
Common stock	45,174	40,201	4,973	12.4%
Retained earnings	45,898	70,400	(24,502)	(34.8)%
Accumulated other comprehensive income	(584)	(3,454)	2,870	—
Total stockholders' equity	90,488	107,147	(16,659)	(15.5)%
Total liabilities and stockholders' equity	$338,516	$365,725	$(27,209)	(7.4)%

Exhibit 17.1

Learning Objective P1: Explain and apply methods of horizontal analysis.

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Comparative Income Statements

Exhibit 17.2

APPLE INC. Comparative Income Statements				
$ millions, except per share data	Current Year	Prior Year	Dollar Change	Percent Change
Net sales	$260,174	$265,595	$(5,421)	(2.0)%
Cost of sales	161,782	163,756	(1,974)	(1.2)%
Gross margin	98,392	101,839	(3,447)	(3.4)%
Research and development	16,217	14,236	1,981	13.9%
Selling, general and administrative	18,245	16,705	1,540	9.2%
Total operating expenses	34,462	30,941	3,521	11.4%
Operating income	63,930	70,898	(6,968)	(9.8)%
Other income, net	1,807	2,005	(198)	(9.9)%
Income before provision for income taxes	65,737	72,903	(7,166)	(9.8)%
Provision for income taxes	10,481	13,372	(2,891)	(21.6)%
Net income	$ 55,256	$ 59,531	(4,275)	(7.2)%
Basic earnings per share	$ 11.97	$ 12.01	$ (0.04)	(0.3)%
Diluted earnings per share	$ 11.89	$ 11.91	$ (0.02)	(0.2)%

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Trend Analysis: Equation

Trend analysis is used to reveal patterns in data across periods.

$$\text{Trend Percent (\%)} = \frac{\text{Analysis period amount}}{\text{Base period amount}} \times 100$$

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Trend Analysis: Illustration

$ millions	Current Yr	1 Yr Ago	2 Yrs Ago	3 Yrs Ago	4 Yrs Ago
Net sales	$260,174	$265,595	$229,234	$215,639	$233,715
Cost of sales	161,782	163,756	141,048	131,376	140,089
Operating expenses	34,462	30,941	26,842	24,259	22,396

Exhibit 17.3

Using the number reported 4 years ago as the base period, we get the following trend percents for each year by dividing that year's amount by the base period amount:

In trend percent	Current Yr	1 Yr Ago	2 Yrs Ago	3 Yrs Ago	4 Yrs Ago
Net sales	111.3%	113.6%	98.1%	92.3%	100.0%
Cost of sales	115.5%	116.9%	100.7%	93.8%	100.0%
Operating expenses	153.9%	138.2%	119.9%	108.2%	100.0%

Exhibit 17.4

Learni
horizontal analysis.

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Line Graph of Trend Percents

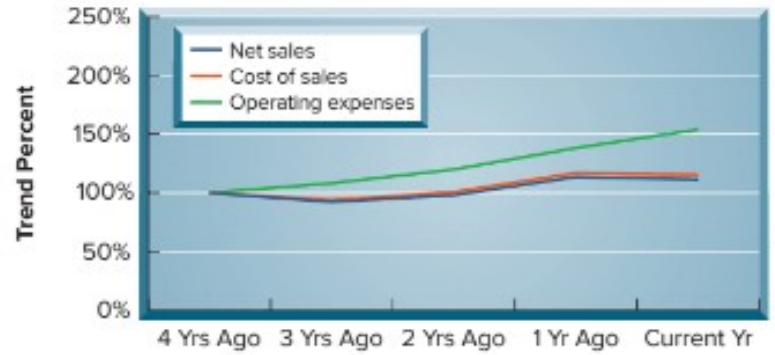

Exhibit 17.5

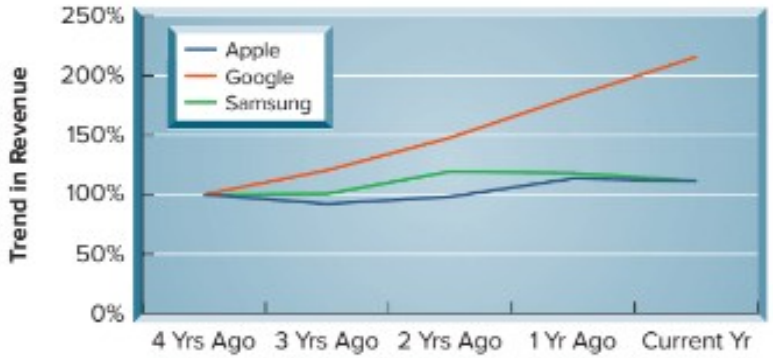

Exhibit 17.6

We can use the trend percentages to construct a graph so we can see the trend over time.

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Learning Objective P2

Describe and apply methods of vertical analysis.

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Vertical Analysis

Common-Size Statements

$$\text{Common-size percent (\%)} = \frac{\text{Analysis amount}}{\text{Base amount}} \times 100$$

Financial Statement	Base Amount
Balance Sheet	Total Assets
Income Statement	Revenues

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Common-Size Balance Sheet

APPLE INC. Common-Size Comparative Balance Sheets			Common-Size Percents*	
$ millions	Current Year	Prior Year	Current Year	Prior Year
Assets				
Cash and cash equivalents	$ 48,844	$ 25,913	14.4%	7.1%
Short-term marketable securities	51,713	40,388	15.3%	11.0%
Accounts receivable, net	22,926	23,186	6.8%	6.3%
Inventories	4,106	3,956	1.2%	1.1%
Vendor nontrade receivables	22,878	25,809	6.8%	7.1%
Other current assets	12,352	12,087	3.6%	3.3%
Total current assets	162,819	131,339	48.1%	35.9%
Long-term marketable securities	105,341	170,799	31.1%	46.7%
Property, plant and equipment, net	37,378	41,304	11.0%	11.3%
Other noncurrent assets	32,978	22,283	9.7%	6.1%
Total assets	$338,516	$365,725	100.0%	100.0%
Liabilities				
Accounts payable	$ 46,236	$ 55,888	13.7%	15.3%
Other current liabilities	37,720	33,327	11.1%	9.1%
Deferred revenue	5,522	5,966	1.6%	1.6%
Commercial paper	5,980	11,964	1.8%	3.3%
Current portion of long-term debt	10,260	8,784	3.0%	2.4%
Total current liabilities	105,718	115,929	31.2%	31.7%
Long-term debt	91,807	93,735	27.1%	25.6%
Other noncurrent liabilities	50,503	48,914	14.9%	13.4%
Total Liabilities	248,028	258,578	73.3%	70.7%
Stockholders' Equity				
Common stock	45,174	40,201	13.3%	11.0%
Retained earnings	45,898	70,400	13.6%	19.2%
Accumulated other comprehensive income	(584)	(3,454)	(0.2)%	(0.9)%
Total stockholders' equity	90,488	107,147	26.7%	29.3%
Total liabilities and stockholders' equity	$338,516	$365,725	100.0%	100.0%

*Percents are rounded to tenths and thus may not exactly sum to totals and subtotals.

Exhibit 17.8

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Common-Size Income Statement

Exhibit 17.9

APPLE INC. Common-Size Comparative Balance Sheets			Common-Size Percents*	
$ millions	Current Yr	Prior Yr	Current Yr	Prior Yr
Net sales	$260,174	$265,595	100.0%	100.0%
Cost of sales	161,782	163,756	62.2%	61.7%
Gross margin	98,392	101,839	37.8%	38.3%
Research and development	16,217	14,236	6.2%	5.4%
Selling, general and administrative	18,245	16,705	7.0%	6.3%
Total operating expenses	34,462	30,941	13.2%	11.6%
Operating income	63,930	70,898	24.6%	26.7%
Other income, net	1,807	2,005	0.7%	0.8%
Income before provision for income taxes	65,737	72,903	25.3%	27.4%
Provision for income taxes	10,481	13,372	4.0%	5.0%
Net income	$ 55,256	$ 59,531	21.2%	22.4%

*Percents are rounded to tenths and thus may not exactly sum to totals and subtotals.

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Data Visualizations

Exhibit 17.10

Common-Size Graphic of Income Statement

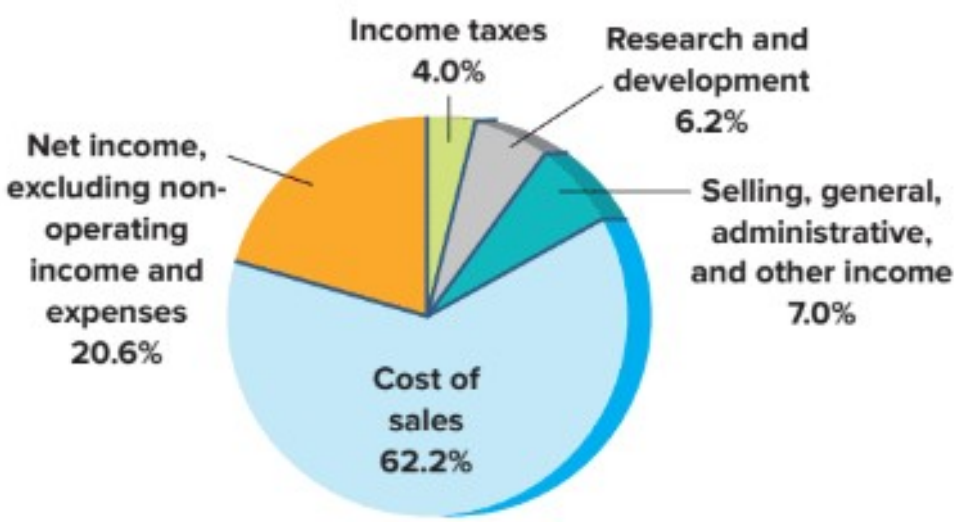
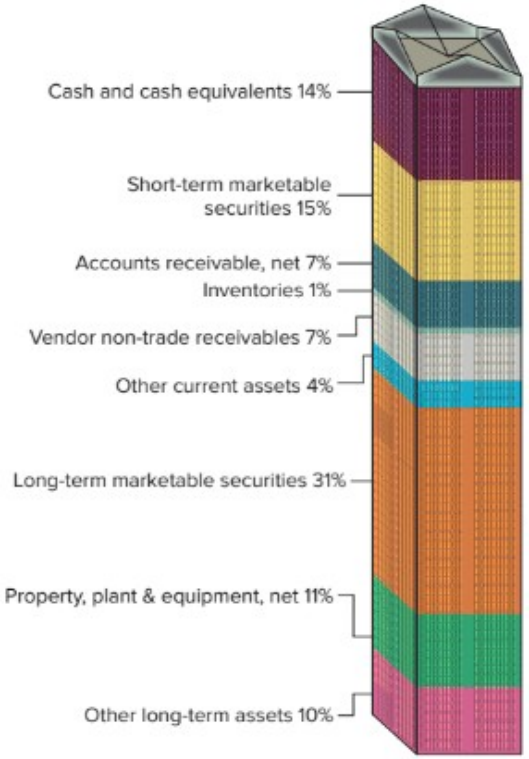

Income taxes 4.0%
Research and development 6.2%
Net income, excluding non-operating income and expenses 20.6%
Selling, general, administrative, and other income 7.0%
Cost of sales 62.2%

Exhibit 17.12

Common-Size Graphic of Asset Components


Cash and cash equivalents 14%
Short-term marketable securities 15%
Accounts receivable, net 7%
Inventories 1%
Vendor non-trade receivables 7%
Other current assets 4%
Long-term marketable securities 31%
Property, plant & equipment, net 11%
Other long-term assets 10%

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Learning Objective P3

Define and apply ratio analysis.

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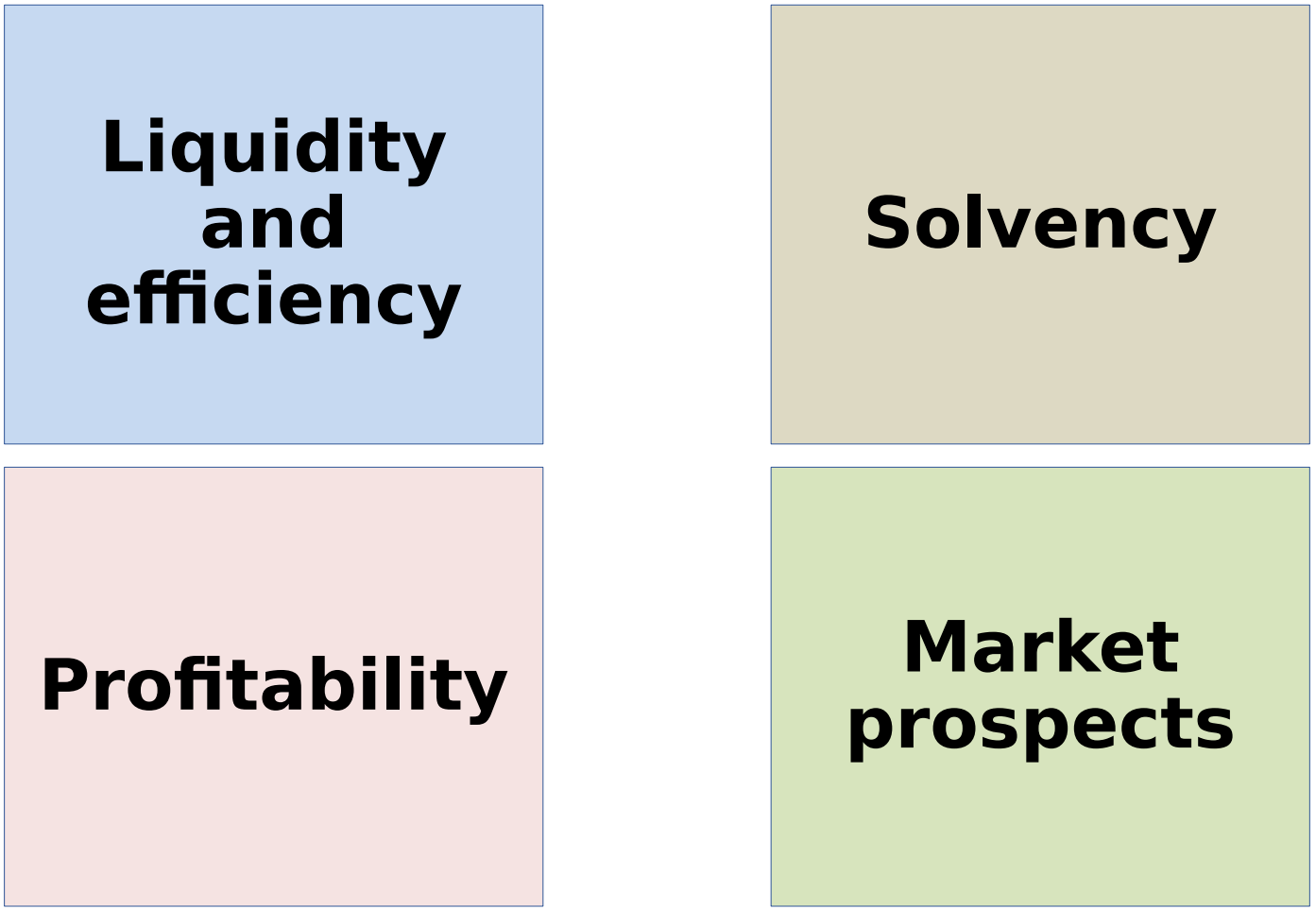
Ratio Analysis



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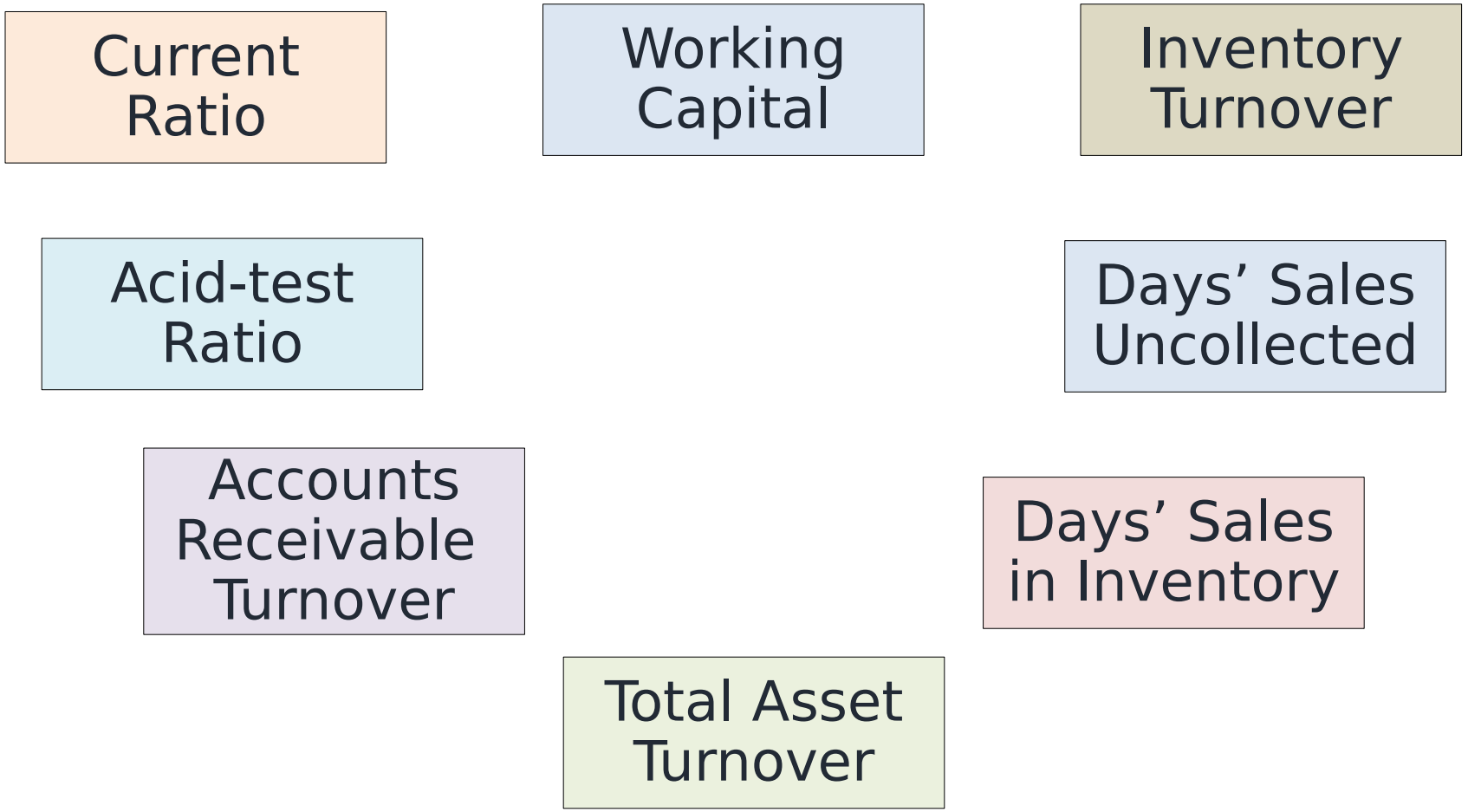
Liquidity and Efficiency



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Working Capital

Working capital is the amount of current assets minus current liabilities.

Exhibit 17.14

Current assets
– Current liabilities
= Working capital

$ millions	Current Yr	Prior Yr
Current assets	$162,819	$131,339
Current liabilities	105,718	115,929
Working capital	**$ 57,101**	**$ 15,410**
Current ratio		
$162,819/$105,71	**1.54 to**	

More working capital suggests a strong liquidity position and an ability to pay debts or continue operating

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Current Ratio

Exhibit 17.14

$ millions	Current Yr	Prior Yr
Current assets	$162,819	$131,339
Current liabilities	105,718	115,929
Working capital	**$ 57,101**	**$ 15,410**
Current ratio		
$162,819/$105,71	**1.54 to**	

- This ratio measures the short-term debt-paying ability of the company.
- A higher current ratio suggests a strong ability to meet current obligations.

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Acid-Test Ratio

Exhibit 17.15

Referred to as Quick

$ millions	Current Yr	Prior Yr
Cash and equivalents	$ 48,844	$ 25,913
Short-term securities	51,713	40,388
Current receivables	22,926	23,186
Total quick assets	$123,483	$ 89,487
Current liabilities	$105,71	$115,92
	$123,483/$105,718 =	1.17 to 1
	$89,487/$115,929	0.77 to

This ratio is like the current ratio but excludes current assets such as inventories and prepaid expenses that may be difficult to quickly convert into cash.

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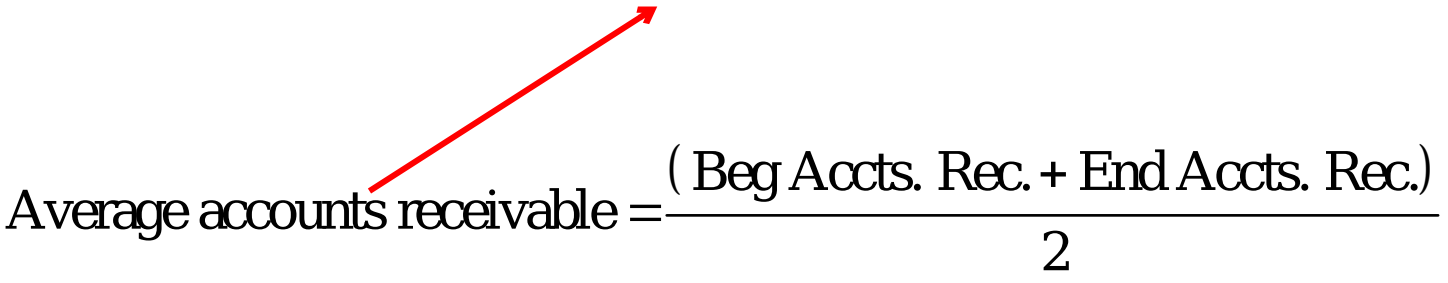
Accounts Receivable Turnover



$$\text{Average accounts receivable} = \frac{(\text{Beg Accts. Rec.} + \text{End Accts. Rec.})}{2}$$

$$\text{Accounts receivable turnover} = \frac{\text{Net sales}}{\text{Average accounts receivable, net}} = \frac{\$260{,}174}{(\$23{,}186 + \$22{,}926)/2} = 11.3 \text{ times}$$

This ratio measures how many times a company converts its receivables into cash.

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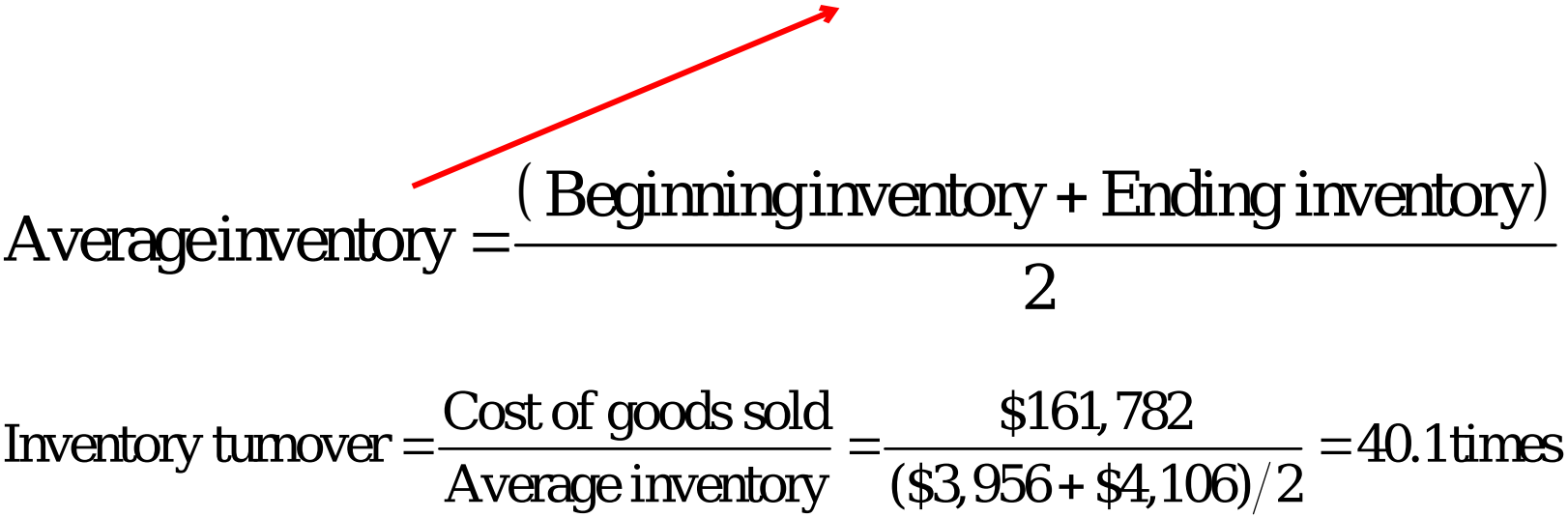
Inventory Turnover



$$\text{Average inventory} = \frac{(\text{Beginning inventory} + \text{Ending inventory})}{2}$$

$$\text{Inventory turnover} = \frac{\text{Cost of goods sold}}{\text{Average inventory}} = \frac{\$161,782}{(\$3,956 + \$4,106)/2} = 40.1 \text{ times}$$

This ratio measures how long a company holds inventory before selling it.

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Days' Sales Uncollected

$$\text{Day's sales uncollected} = \frac{\text{Accounts receivable, net}}{\text{Net sales}} \times 365 = \frac{\$22{,}926}{\$260{,}174} \times 365 = 32.2 \text{ days}$$

This ratio measures how frequently a company collects its accounts receivable.

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Days' Sales in Inventory

$$\text{Day's sales in inventory} = \frac{\text{Ending inventory}}{\text{Cost of goods sold}} \times 365 = \frac{\$4{,}106}{\$161{,}782} \times 365 = 9.3 \text{days}$$

This ratio is a useful measure in evaluating inventory liquidity.

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Total Asset Turnover

$$\text{Total asset turnover} = \frac{\text{Net sales}}{\text{Average total assets}}$$

$$\text{Average assets} = \frac{(\text{Beginning assets} + \text{Ending assets})}{2}$$

$$\text{Total asset turnover} = \frac{\text{Net sales}}{\text{Average total assets}} = \frac{\$260,174}{(\$338,516 + \$365,725)/2} = 0.74 \text{ times}$$

- This ratio measures a company's ability to use its assets to generate sales.
- It is an important indication of operating efficiency.

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Solvency

Debt Ratio

Equity Ratio

Debt-to-Equity Ratio

Times Interest Earned

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Debt Ratio and Equity Ratio

Apple, $ millions	Current Year	Ratios	
Total liabilities	$248,028	**73.3%**	**[Debt ratio]**
Total equity	90,488	**26.7%**	**[Equity ratio]**
Total liabilities and equity		100.0	

$248,028 ÷ $338,516 =

- The *debt ratio* shows total liabilities as a percent of total assets.
- The *equity ratio* shows total equity as a percent of total assets.

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Debt-to-Equity Ratio

$$\text{Debt-to-equity ratio} = \frac{\text{Total liabilities}}{\text{Total equity}} = \frac{\$248{,}028}{\$90{,}488} = 2.74$$

This ratio measures what portion of a company's assets are contributed by creditors. A larger debt-to-equity ratio implies less opportunity to expand through use of debt financing.

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Times Interest Earned

	Net income
+	Interest expense
+	Income taxes
=	Income before interest and taxes

$$\frac{\$55{,}256 + \$3{,}576 + \$10{,}481}{\$3{,}576} = 19.4 \text{ times}$$

This is the most common measure of a company's ability to pay interest expense.

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Profitability

Profit Margin

Return on Total Assets

Return on Equity

Gross Margin Ratio

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Gross Margin Ratio

$$\text{Gross margin ratio} = \frac{\text{Net sales} - \text{Cost of goods sold}}{\text{Net sales}} = \frac{\$260{,}174 - \$161{,}782}{\$260{,}174} = 37.8\%$$

This ratio measures a company's percent of gross margin in each dollar of net sales.

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Profit Margin

$$\text{Profit margin} = \frac{\text{Net income}}{\text{Net sales}} = \frac{\$55{,}256}{\$260{,}174} = 21.2\%$$

This ratio measures a company's ability to earn net income from each sales dollar.

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Return on Total Assets

$$\text{Return on total asset} = \frac{\text{Net income}}{\text{Average total assets}} = \frac{\$55{,}256}{(\$338{,}516 + \$365{,}725)/2} = 15.7\%$$

- Return on total assets measures how well assets are utilized by the company.
- The relation between profit margin, total asset turnover, and return on total assets is:

$$\text{Profit margin} \times \text{Total asset turnover} = \text{Return on total assets}$$

$$\frac{\text{Net income}}{\text{Net sales}} \times \frac{\text{Net sales}}{\text{Average total assets}} = \frac{\text{Net income}}{\text{Average total assets}}$$

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Return on Equity

$$\frac{\$55{,}256}{(\$107{,}147 + \$90{,}488)/2} = 55.9\%$$

This measure indicates the company's ability to earn income for common stockholders.

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Market Prospects

Price Earnings Ratio

Dividend Yield

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Price-Earnings Ratio

$$\text{Price-earning ratio} = \frac{\text{Market price per common share}}{\text{Earning per share}} = \frac{\$293.65}{\$11.97} = 24.5$$

This ratio measures market expectations for future growth.

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Dividend Yield

$$\text{Dividend yield} = \frac{\$3.00}{\$293.65} = 1.0\%$$

This ratio is used to compare the dividend-paying performance of different companies.

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Summary of Ratios[1]

Exhibit 17.16

Ratio	Formula	Measure of
Liquidity and Efficiency		
Current ratio	$=\frac{\text{Current assets}}{\text{Current liabilities}}$	Short-term debt-paying ability
Acid-test ratio	$=\frac{\text{Cash + Short-term investment + Current receivables}}{\text{Current liabilities}}$	Immediate short-term debt-paying ability
Accounts receivable turnover	$=\frac{\text{Net sales}}{\text{Average accounts receivable, net}}$	Efficiency of collection
Inventory turnover	$=\frac{\text{Cost of goods sold}}{\text{Average inventory}}$	Efficiency of inventory management
Days' sales uncollected	$=\frac{\text{Accounts receivable, net}}{\text{Net sales}}\times 365$	Liquidity of receivables
Days' sales in inventory	$=\frac{\text{Ending inventory}}{\text{Cost of goods sold}}\times 365$	Liquidity of inventory
Total asset turnover	$=\frac{\text{Net sales}}{\text{Average total assets}}$	Efficiency of assets in producing sales
Solvency		
Debt ratio	$=\frac{\text{Total liabilities}}{\text{Total assets}}$	Creditor financing and leverage
Equity ratio	$=\frac{\text{Total equity}}{\text{Total assets}}$	Owner financing

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Summary of Ratios[2]

Exhibit 17.16

Debt-to-equity ratio	$= \frac{\text{Total liabilities}}{\text{Total equity}}$	Debt versus equity financing
Times interest earned	$= \frac{\text{Income before interest expense and income tax expense}}{\text{Interest expense}}$	Protection in meeting interest payments
Profitability		
Profit margin ratio	$= \frac{\text{Net income}}{\text{Net sales}}$	Net income in each sales dollar
Gross margin ratio	$= \frac{\text{Net sales} - \text{Cost of goods sold}}{\text{Net sales}}$	Gross margin in each sales dollar
Return on total assets	$= \frac{\text{Net income}}{\text{Average total assets}}$	Overall profitability of assets
Return on equity	$= \frac{\text{Net income}}{\text{Average total equity}}$	Profitability of owner investment
Basic earnings per share	$= \frac{\text{Net income} - \text{Preferred dividends}}{\text{Weighted-average common shares outstanding}}$	Net income per common share
Market Prospects		
Price-earnings ratio	$= \frac{\text{Market price per common share}}{\text{Earnings per share}}$	Market value relative to earnings
Dividend yield	$= \frac{\text{Annual cash dividends per share}}{\text{Market price per share}}$	Cash return per common share

ratio analysis.

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Learning Objective A1

Summarize and report results of analysis.

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Analysis Reporting

1. **Executive Summary**
2. **Analysis Overview**
3. **Evidential Matter**
4. **Assumptions**
5. **Key Factors**
6. **Inferences**

Learning Objective A1: Summarize and report results of analysis.

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Learning Objective A2

Appendix 17A
Explain the form and assess the content of a complete income statement.

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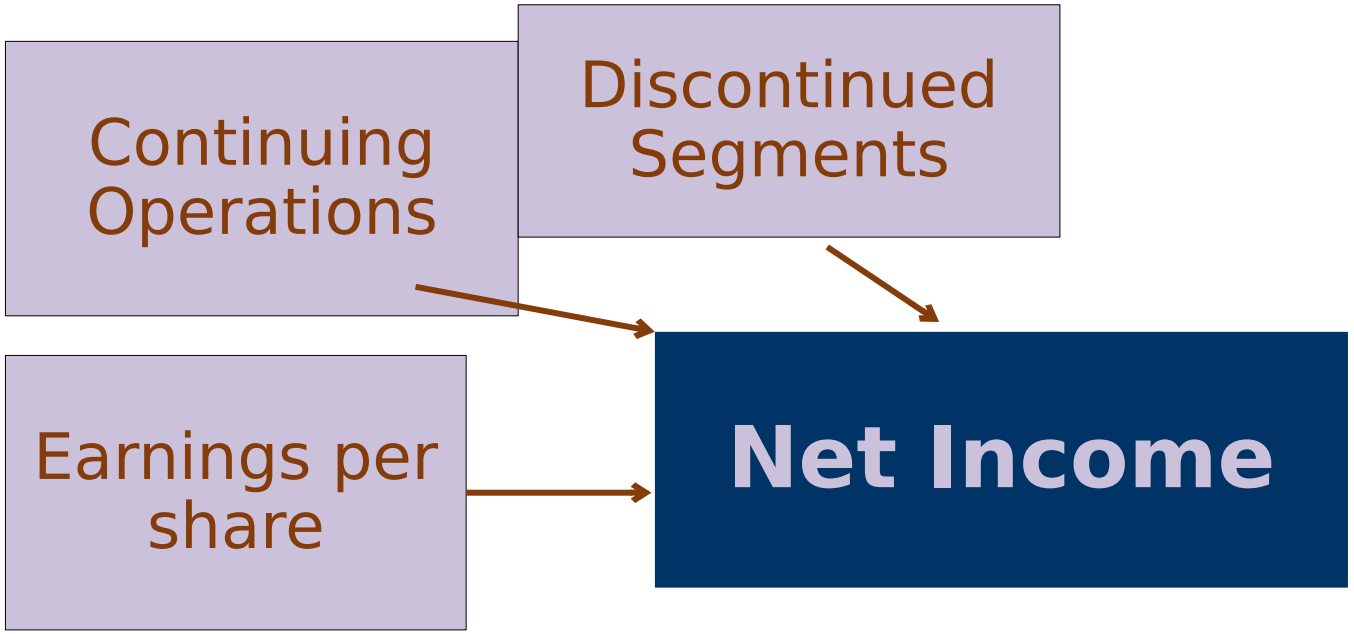
Sustainable Income

Changes in Accounting Principles: Retrospective application on prior financial statements.



Learning Objective A2: Explain the form and assess the content of a complete income statement.

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Income Statement All-inclusive

ComUS
Income Statement
For Year Ended December 31

	Net sales		$8,478,000
	Operating expenses		
	Cost of goods sold	$5,950,000	
	Depreciation expense	35,000	
	Other selling, general, and administrative expenses	515,000	
	Interest expense	20,000	
①	Total operating expenses		(6,520,000)
	Other unusual and/or infrequent gains (losses)		
	Loss on plant relocation		(45,000)
	Gain on sale of surplus land		72,000
	Income from continuing operations before taxes		1,985,000
	Income tax expense		(595,500)
	Income from continuing operations		1,389,500
	Discontinued segment		
②	Income from operating Division A (net of $180,000 taxes)	420,000	
	Loss on disposal of Division A (net of $66,000 tax benefit)	(154,000)	266,000
	Net income		$ 1,655,500
	Earnings per common share (200,000 outstanding shares)		
③	Income from continuing operations		$ 6.95
	Discontinued operations		1.33
	Net income (basic earnings per share)		$ 8.28

Exhibit 17A.1

Learning Objective A2: Explain the form and assess the content of a complete income statement.

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End of Chapter 17

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